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Instructions for Form 1118
(Revised January 1988)

Computation of Foreign Tax Credit—Corporations

(Section references are to the Internal Revenue Code unless otherwise noted)

Paperwork Reduction Act Notice.— We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Important Changes You Should Note

The Tax Reform Act of 1986 significantly changed the way the foreign tax credit is computed for tax years beginning after 1986. The first major change is in the separate limitation categories. One category of income, section 904(d)(1)(A) interest, has been deleted and five new categories of income have been added. The new categories of income are: 1) passive income, 2) high withholding tax interest, 3) financial services income, 4) shipping income, and 5) dividends from each noncontrolled foreign corporation.

The manner of computing the deemed paid credit under sections 902 and 960 has also been changed.

In addition, a new schedule has been developed for corporations to show how they have allocated their separate limitation losses and the beginning and ending balances, and adjustments to their overall foreign losses.

Schedule G (Form 1118), Separate Limitation Losses and Overall Foreign Losses, is the new schedule and it must be completed and attached to Form 1118 when a corporation has either type of loss.

Form 1118 must be filed even if there is a loss in a separate limitation because the separate limitation loss may be used to reduce other separate limitations.

Definitions of New Categories of Income

Passive Income

Passive income is income that is generally considered personal holding company income. Passive income also includes income that is generally considered passive foreign investment income. Certain types of income are not considered passive income. These types of income are: 1) any other type of income listed in section 904(d)(1), 2) any export financing interest (as defined in section 904(d)(2)(G)), 3) any highly taxed income (as defined in section 904(d)(2)(F)), and 4) any foreign oil and gas extraction income.

High Withholding Tax Interest

High withholding tax interest is any interest that is subject to a withholding tax of 5% or more by a foreign country or possession of the U.S. However, high withholding tax interest does not include export financing interest.

Certain Interest Not To Be Treated as High Withholding Tax Interest

Interest income from qualified loans is not treated as high withholding tax interest if the interest is from loans made to countries listed in section 1201(e)(2)(H) of the Tax Reform Act of 1986. The interest is not included in the high withholding tax interest category for interest received or accrued in any tax year beginning after 1986 through tax years beginning before 1990. For tax years beginning after 1989, the amount of interest not treated as high withholding tax interest is subject to a percentage reduction of 20% per year ending with none of the interest being exempt from the separate category limitation for years beginning after 1994.

Financial Services Income

Financial services income is generally income that is not passive income but is income that is derived in the active conduct of a banking or similar business or income that would be insurance income as defined under section 953. Any entity that is in the trade or business of banking, insuring, financing, or other similar business for the entire tax year may also include passive income in financial services income. Financial services income does not include high withholding tax interest or export financing interest.

Shipping Income

Shipping income is any type of income that is generally considered foreign base shipping income under section 954(f).

Noncontrolled Foreign Corporation

A noncontrolled foreign corporation is a foreign corporation of which the U.S. person owns 10% but no more than 50% of its stock. A controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of earnings and profits for periods during which it was a controlled foreign corporation.

Certain Amounts Received From Controlled Corporations by U.S. Person May Be Placed in Categories

Generally, amounts received from a controlled foreign corporation by a U.S. shareholder may not be categorized as a certain type of income for the foreign tax credit. If the U.S. shareholder of a controlled foreign corporation is able to properly allocate the income received under rules set forth by regulations, the shareholder may, however, allocate the income to the proper category. For example, if a deemed dividend is received by a U.S. shareholder of a controlled foreign corporation, the U.S. shareholder may allocate the income among categories of income to the extent that the income is attributable to income in a category. Interest, rents, and royalties received or accrued from a controlled corporation may be allocated among different categories to the extent allowed by regulations. Any dividend received by a U.S. shareholder from a controlled foreign corporation may be allocated among categories to the proportion of earnings and profits in a certain category divided by earnings and profits for the year.

For purposes of this paragraph, the categories in which the income may be placed are: 1) passive income, 2) high withholding tax interest, 3) financial services income, 4) shipping income, and 5) dividends from each noncontrolled foreign corporation.

Losses From Foreign and U.S. Sources

Separate Limitation Foreign Losses.— Separate limitation losses will reduce U.S. sourced income only after first reducing foreign income in other categories. The losses shall be allocated among the other categories of foreign income in a proportionate manner. If any income is received in a prior year's losses category, the income will first be allocated to the category of income against which the loss was applied. When the loss category's income exceeds the aggregate loss taken, the income remains in the original category of income.

Special Rules for Losses From U.S. Sources.—If there is a loss from U.S. sources in any tax year beginning after 1986, the loss (to the extent the loss does not exceed the separate limitation incomes for the year) shall be allocated among such incomes and proportionately reduce income in the separate limitations.

For more information on foreign and U.S. losses, see the instructions for lines 6b and 6d, Part II, Schedule B.

Deemed Paid Tax Credit Under Sections 902 and 960

The deemed paid tax credit has also significantly changed for tax years beginning after 1986. Although the same percentages (10%) of ownership in the 1st tier and the percentage of net holdings in 2nd and 3rd tier foreign corporations (5%) apply, the credit is now based on undistributed earnings and profits earned in tax years

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beginning after 1986 and taxes paid or accrued in tax years beginning after 1986. To compute the credit, multiply the post-1986 income taxes paid by the foreign corporation times a fraction, the numerator of which is the dividend paid by the foreign corporation, and the denominator of which is the post-1986 undistributed earnings of the foreign corporation.

Post-1986 Undistributed Earnings and Taxes

Post-1986 undistributed earnings are earnings and profits of a foreign corporation computed under sections 964 and 986 for tax years beginning after 1986 as of the close of the tax year for which the dividends were distributed. For purposes of computing "undistributed earnings and profits" for Schedules C, D, and E, the amount of dividends paid during the year does not reduce the earnings of the foreign corporation.

Post-1986 foreign income taxes are income taxes paid during the tax year in which the dividend is distributed and prior year post-1986 foreign income taxes paid by the foreign corporation. Corporations must, however, reduce the post-1986 taxes by taxes used in computing the deemed paid credit in earlier years.

Special Rule When a Corporation Acquires a 10% or More Ownership in a Foreign Corporation After 1986

If a domestic corporation acquires a 10% or more ownership in a foreign corporation after 1986, the calculation of the post-1986 undistributed earnings and the post-1986 income taxes of the foreign corporation begin with the first day of the first year in which the ownership requirements are met.

Foreign Taxes Used To Provide Subsidies

Foreign taxes paid to a foreign country or U.S. possession that result in a subsidy (directly or indirectly) to the corporation, related person (as described in section 482), or any person that is a party to the transaction or a related transaction cannot be used in computing the foreign tax credit. This rule applies to foreign taxes paid or accrued in tax years beginning after 1986.

New Source Rules

For tax years beginning after 1986, new source rules will affect the computation of gross income and the foreign tax credit. These new rules are highlighted below.

Source of Personal Property

Personal property will generally be sourced in the U.S. if the seller is a U.S. person, and outside the U.S. if the person is a nonresident of the U.S. For more information, see section 865.

Source of Space and Oceanic Activities

Generally, income derived in space or oceanic activities will be sourced in the U.S. if the person providing the services is a U.S. person, and outside the U.S. if the person providing the services is not a U.S. person. For more information, see section 863(d).

Source of International Communications Income

The income from transmission of communications or data from the U.S. to a foreign country or from a foreign country to the U.S. by a U.S. person is sourced 50% in the U.S. and 50% outside the U.S. In the case of communications income of a foreign person, the income will generally be considered foreign sourced. However, if the foreign person has a fixed place of business in the U.S., international communications income will be considered sourced in the U.S.

High-Taxed Income

High-taxed income is considered as part of the all other income from outside the U.S. category. High taxed income is income from foreign sources whose total income taxes and deemed paid taxes (not including the dividend gross-up) on that income exceed the amount of taxes that would have been paid if the corporation were taxed at the highest rate of tax under section 11.

General Instructions

A. Corporations Required To File Form 1118.—Every corporation that elects the benefits of the foreign tax credit under section 901 must attach Form 1118 to its income tax return. The form must be carefully filled in with all the information called for and with the calculation of credits indicated. (Section 1.905-2(a)(2) of the regulations.)

Note: *A regulated investment company that has made an election under section 853 cannot claim the foreign tax credit (or deduction). (Section 853(b)(1).)*

B. Foreign Taxes for Which Credit May Be Claimed.—The credit may be claimed for income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or to any U.S. possession, and for taxes deemed paid or accrued under sections 902 and 960. (Section 1.901-1(a)(2) of the regulations.)

The term "foreign country" means any foreign state or possession of the U.S., or political subdivision or agency or instrumentality of a foreign state or U.S. possession. (Section 1.901-2(g) of the regulations.)

See section 1.901-2 of the regulations for a definition of income, war profits, or excess profits taxes. Also, see section 1.903-1 of the regulations for a definition of taxes paid in lieu of income taxes.

Any income, war profits, and excess profits taxes paid or accrued to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered a tax for purposes of sections 275(a) and 901 if: (1) the taxpayer has no economic interest in the oil or gas to which section 611(a) applies; and (2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale. (Section 901(f).)

Foreign taxes paid or accrued on foreign oil related income do not qualify for the foreign tax credit if the Secretary determines that the foreign law is designed, or operates, to impose a greater tax on foreign oil related income than the tax that is generally imposed on income that is neither foreign oil related income nor foreign oil and gas extraction income. Taxes not allowed as a credit under this rule will, however, be allowed as a deduction. (Section 907(b).)

No credit (or deduction) is allowed for any tax paid or accrued to a foreign country or U.S. possession with respect to taxable income used in computing the section 936 credit. (Section 936(c).)

No credit is allowed for taxes paid or accrued by a FSC on foreign trade income (other than nonexempt foreign trade income determined without regard to administrative pricing rules.) (Section 901(h).)

No credit (or deduction) is allowed for any tax paid or accrued to a foreign country or U.S. possession with respect to any distribution from a corporation to the extent the distribution is attributable to periods during which the corporation is a possessions corportion, and a dividends-received deduction is allowable with respect to the distribution, or to the extent that the distribution is received in connection with a liquidation or other transaction in which gain or loss is not recognized. (Section 901(g).)

No credit (or deduction) is allowed for any income, war profits, or excess profits taxes paid or accrued to any foreign country or U.S. possession attributable to income excluded under section 814.

A credit is not allowed for excess tax payments to a foreign country with which the U.S. has a tax treaty if such excess would be refunded by the foreign country under a tax treaty or overpayment claim.

No credit is allowed for amounts representing interest or penalties.

For reduction in the amount of foreign taxes for which a credit may be claimed, see General Instruction I.

C. Taxes Against Which Credit Is Allowed.—The foreign tax credit is allowed against income tax imposed by chapter 1 (reduced by the section 936 credit) but not against any: (1) tax on accumulated earnings imposed by section 531; (2) personal holding company tax imposed by section 541; (3) additional tax imposed for the tax year under section 1351 (relating to recoveries of foreign expropriation losses); (4) increase in tax under section 47 (relating to dispositions of investment credit property); and (5) tax on electing small business corporations imposed by sections 1374 or 1375.

Foreign corporations may not take the credit against any tax imposed by section 881 on income not effectively connected with the conduct of a trade or business within the U.S. (Section 906(b)(3)).

D. No Deduction If a Credit Is Claimed.—If a corporation elects for any tax year to claim a credit for taxes to any extent, the election will apply to income, war profits, and excess profits taxes paid or accrued in the tax year to all foreign countries and U.S. possessions and no portion of the tax will be allowed as a deduction in the tax year or any succeeding tax year. (Section 1.901-1(c) of the regulations.)

The election for any tax year may be made or changed at any time before the end of the period prescribed for making a claim for credit or refund of tax for the tax year. (Section 901(a).)

See section 908(b) concerning the deductibility of the amount of the foreign tax credit denied because of the application of the international boycott provisions. Also, see section 907(b) concerning the deductibility of certain foreign oil and gas extraction taxes.

Members of an affiliated group electing under section 243 to deduct 100% of qualifying dividends received from members of the same affiliated group are treated as one taxpayer for purposes of making the election under section 901(a). (Section 243(b)(3)(B).)

E. When Foreign Tax Credit Can Be Taken.—You can take the credit for the year in which the taxes were paid or accrued depending on the method of accounting used. However, if you report on the cash basis, you can elect to claim the credit for accrued taxes. You can make the election by checking the appropriate box in the heading for column 1 of Schedule B. This election must be followed in all subsequent years. (Section 905(a).)

F. Credit for Tax Accrued but Not Paid.—If you claim a credit for tax accrued but not paid, the Internal Revenue Service may require you to furnish a bond on Form 1117 as a condition precedent to the allowance of the credit. (Section 1.905-4 of the regulations.)

G. Proof of Credits.—Payment or accrual of each item of foreign tax for which you claim a credit must be substantiated by attaching to Form 1118 a receipt if the tax is paid, or the foreign tax return on which the tax is based if the tax is accrued but not paid. If such receipt or return is in a foreign language, a certified translation must also be attached. IRS may accept secondary evidence of foreign taxes paid or accrued if it can be established to its satisfaction that it is impossible to furnish a receipt, return, or direct evidence of tax withheld. (Section 1.905-2 of the regulations.)

Foreign taxes paid or accrued by a foreign corporation for which a deemed paid credit is claimed under section 902 or 960 must be similarly substantiated. (Secs. 1.902-1(f) and 1.960-1(e) of the regulations.)

If you are claiming as part of your foreign tax credit any foreign taxes paid or accrued that resulted from an audit adjustment by the foreign taxing authority, attach a statement to Form 1118 identifying these taxes.

H. Other Rules for Computing the Foreign Tax Credit

Entities Treated as Foreign.—For purposes of the deemed paid credit, the term "foreign corporation" includes: (1) a DISC or former DISC (as defined in section 992(a)), but only with respect to dividends from the DISC or former DISC to the extent such dividends are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources outside the U.S.; and (2) a contiguous country life insurance branch, which has made an election to be treated as a foreign corporation under section 814(g).

Dividend Gross-up.—Under section 78, taxes deemed paid by a domestic corporation under sections 902 and 960(a) with respect to distributions by a foreign corporation must be included in income as dividend gross-up. (See section 1.960-3(b) of the regulations for exceptions.)

I. Reduction in Foreign Taxes.—*(1) Taxes on Foreign Oil and Gas Extraction Income.*—The amount of any foreign taxes paid, accrued, or deemed paid with respect to foreign oil and gas extraction income which may be taken into account for purposes of section 901 must be reduced by the amount (if any) by which the amount of such taxes exceeds the product of the amount of foreign oil and gas extraction income for such tax year and the applicable percentage from section 907(a)(2). (Section 907(a).)

See section 907(c)(4) for the rules regarding the recharacterization of foreign oil and gas extraction losses for tax years beginning after 1982.

For computation of the reduction, see separate Schedule F, Form 1118.

(2) Taxes on Foreign Mineral Income.—The amount of any income, war profits, and excess profits taxes paid or accrued, or deemed paid during the tax year to any foreign country or U.S. possession with respect to foreign mineral income derived from sources within such country or possession must be reduced by the lesser of (a) the amount of such foreign taxes minus the amount of U.S. tax computed under Chapter 1 of the Code with respect to such foreign mineral income, or (b) the amount of U.S. tax which would be computed under Chapter 1 of the Code with respect to such foreign mineral income without regard to the deduction for percentage depletion under section 613 minus the amount of U.S. tax computed under Chapter 1 of the Code with respect to such foreign mineral income. The reduction must be made on a country-by-country basis. (Section 1.901-3(a)(1) of the regulations.)

The reduction applies only if a deduction for percentage depletion under section 613 was allowed with respect to any part of such foreign mineral income. (Section 1.901-3(a)(3)(i) of the regulations.)

A schedule must be attached showing the computation described in (a) and (b) above of the foreign and U.S. tax with respect to foreign mineral income. (Section 1.901-3(a)(3)(iv) of the regulations.)

(3) Failure To Furnish Return Required Under Section 6038 (Form 5471 and Schedule M).—For each failure of a domestic corporation to furnish any return or any information in any return required under authority of section 6038 by the prescribed date, in the application of sections 902 and 960, all taxes paid or deemed paid by all foreign corporations controlled by such domestic corporation must be reduced by 10%, and in the application of section 901, all taxes paid or deemed paid (except taxes deemed paid under section 904(c) and taxes reduced in the application of sections 902 and 960) by such corporation must be reduced by 10%. If such failure continues for 90 days or more after the date of written notice by IRS to such domestic corporation, the reductions are 10% plus 5% for each 3-month period or fraction thereof during which such failure continues after expiration of the 90-day period.

A penalty of $1,000 is also imposed for failing to supply the information for each controlled foreign corporation under section 6038 when required. Additionally, if the required information is not submitted within 90 days after the Secretary has mailed notice to the U.S. person, an additional $1,000 penalty (per corporation) is charged for every 30 days that the information is not submitted. The increase in any penalty under section 6038(b)(2) may not exceed $24,000. See section 6038(c)(3) for rules coordinating these penalties.

(4) International Boycott Provisions and Form 5713.—Generally, if a person or any corporation controlled by that person agrees to participate in, or cooperate with, an international boycott, that person must file **Form 5713**, International Boycott Report, and reduce the total taxes available for credit or the credit otherwise allowable.

If the taxes specifically attributable to boycott operations can be determined, reduce the total taxes available for credit by entering this amount on Schedule B, Part II, line 3.

However, if the above determination cannot be made, compute the reduction by multiplying the credit otherwise allowable by the international boycott factor. This reduction shall be made against the credit otherwise allowable and entered on Schedule B, Part III, line 11.

For additional information, see Form 5713 and the Instructions for Form 5713.

(5) Reduction of Taxes for Taxes Paid to Certain Foreign Countries (section 901(j)).—Foreign taxes paid to certain foreign countries may not be used in computing the foreign tax credit. These taxes may also not be used in the computation of the deemed paid credit under section 902 or 960.

Foreign taxes paid to any foreign country will be denied if any of the following conditions apply: (1) if the U.S. does not have relations with that country, unless the foreign country is able to purchase arms or services under the Arms Export Control Act, (2) if the U.S. has severed relations with that foreign country, (3) if the U.S. has not severed relations with the foreign country, but does not conduct relations with the foreign country, or (4) if the foreign country is on a list provided by the Secretary of State under the Export Administration Act of 1979, as amended, and is identified as harboring international terrorism. The amount of taxes ineligible for the foreign tax credit will be allowed as a deduction.

This provision is effective for the period beginning the later of January 1, 1987, or 6 months after the country meets any of the provisions described above and ends with the date that the Secretary certifies that the country does not meet any of the above conditions.

Special Rule for Foreign Taxes Paid to South Africa

In addition to any denial of the foreign credit for foreign taxes paid or accrued to South Africa under section 901(j)(1)(A) and (B), no foreign tax credit will be allowed for foreign taxes paid or accrued to South Africa after December 31, 1987, and ending with the date the Secretary of State notifies the Secretary of the Treasury that South Africa meets the requirements of section 311(c) of the Comprehensive Anti-Apartheid Act of 1986. For more information, see section 901(j)(2)(C).

J. Limitation on Credit.—The credit must be computed using the overall limitation. Under the overall limitation, the credit is

limited to that percentage of the total U.S. income tax against which the credit is allowed. The ratio is taxable income from sources without the U.S. (but not in excess of total taxable income) to total taxable income. (Section 904(a).)

The credit must be computed separately (using a separate Form 1118) for foreign taxes paid or accrued with respect to: (1) passive income; (2) high withholding tax interest; (3) financial services income; (4) shipping income; (5) dividends from each noncontrolled section 902 corporation; (6) dividends from a DISC or former DISC; (7) foreign trade income of a FSC; (8) distributions of a FSC or former FSC; and (9) all other income from sources outside the U.S. On each Form 1118, the credit must be computed using the overall limitation.

The limitation may be increased under section 960(b) in a tax year in which you receive a distribution of earnings and profits in respect of which you were required under section 951 to include an amount in gross income for a prior tax year. See section 960 and section 1.960-4 of the regulations for computation of the increase in the limitation.

K. Computation of Taxable Income.—*(1) General Source Rules* — Determine gross income, applicable deductions, and taxable income from sources outside the U.S. and within each foreign country or U.S. possession in accordance with sections 638 and 861 through 864 and the related regulations, and applicable tax treaties. All income from sources outside the U.S., including high seas income, must be taken into account.

Section 904(g) requires that certain income, which was formerly considered foreign sourced, be considered U.S. sourced. This is income from a U.S.-owned foreign corporation that is subpart F income, foreign personal holding company income, interest income, or dividend income.

The U.S. shareholder's portion of subpart F, foreign personal holding company income or income of a U.S. shareholder of a qualified electing fund that must be considered U.S. sourced is the portion of the income that is attributable to the foreign corporation's U.S. sourced income.

Interest received by a shareholder or a person related to the shareholder of a U.S.-owned foreign corporation is U.S. sourced income to the extent that the interest is properly allocable to the corporation's U.S. sourced income.

The amount of the dividend paid to a shareholder of a U.S.-owned foreign corporation that is U.S. sourced income is the dividend multiplied by the earnings and profits of the corporation for the tax year attributable to U.S. sources, divided by total earnings and profits for the tax year.

U.S.-owned foreign corporations whose earnings and profits are less than 10% U.S. sourced for the tax year are exempt from the interest and dividend provisions of section 904(g). (Section 904(g)(5).)

Certain U.S. corporations are treated as U.S.-owned foreign corporations. When interest of a domestic corporation is treated as foreign sourced interest under section 861(a)(1)(B) or dividends of a domestic corporation are treated as foreign sourced dividends under section 861(a)(2)(A), the domestic corporation paying the interest or dividends is treated as if it were a U.S.-owned foreign corporation.

Section 864(d) defines "factoring income" and shows how to determine the source of "factoring income." "Factoring income" is derived when a person acquires a trade or service receivable from a related person. "Factoring income" is earned by the related person when it collects the receivable. "Factoring income" is treated as interest on a loan to the obligor of the receivable for source of income rules, and the income is included in section 904(d)(1)(A) income when computing the foreign tax credit.

(2) Capital Gains.—Taxable income from sources outside the U.S. includes gain from the sale or exchange of capital assets (including any gain so treated under section 1231) only in an amount equal to foreign source capital gain net income (lesser of capital gain net income from sources outside the U.S. or capital gain net income from all sources) reduced by the "rate differential portion" of foreign source net capital gain.

See section 904(b)(3)(D) for a definition of "rate differential portion."

The rate differential portion will not apply in tax years beginning after June 30, 1987, since the preferential treatment of capital gains is repealed.

For purposes of the credit, taxable income from all sources includes gain from the sale or exchange of capital assets only in an amount equal to capital gain net income reduced by the "rate differential portion" of net capital gain. (See above.)

Any net capital loss including any amount that is a short-term capital loss under section 1212(a) from sources outside the U.S., to the extent taken into account in determining capital gain net income, is reduced by the "rate differential portion" of the excess of net capital gain from sources within the U.S. over net capital gain.

Generally, the term "capital gain net income" means the excess of the gains from the sales or exchanges of capital assets over the losses from such sales or exchanges.

See section 861(a)(6) for gain from sources outside the U.S. treated as gain from sources within the U.S. in the case of sales or exchanges of certain personal property.

(3) Recapture of Foreign Losses.—Generally, if in any tax year you sustain an overall foreign loss, then in each succeeding tax year you must treat as income from sources within the U.S. a portion of your taxable income from sources outside the U.S. That portion is the lesser of: (a) the amount of the overall foreign loss not recaptured in prior years; or (b) 50% (or any higher percentage you choose) of your taxable income from sources outside the U.S. Generally, an "overall foreign loss" is the amount by which gross income from sources outside the U.S. is exceeded by the total deductions applicable to such income. However, see section 904(f) for certain losses not taken into account and special rules governing dispositions of property used predominantly outside the U.S. in a trade or business.

The recapture rules are applied separately to each category of income listed in General Instruction J: (1) passive income; (2) high withholding tax interest; (3) financial services income; (4) shipping income; (5) dividends from each noncontrolled foreign corporation; (6) dividends from a DISC or former DISC; (7) foreign trade income of a FSC; (8) distributions from a FSC or former FSC; and (9) all other income from sources outside the U.S.

(4) Coordination with section 936.—Taxable income used in computing the section 936 credit (if any) is excluded from taxable income in computing the foreign tax credit limitation. (Section 904(b)(4).)

(5) Foreign Corporations Claiming Credit.—For purposes of computing the foreign tax credit limitation, taxable income includes only taxable income that is effectively connected with the conduct of a trade or business within the U.S. (Section 906(b)(2).)

L. Carryback and Carryover of Excess Taxes Paid.—Taxes paid or accrued, or deemed paid under sections 902 and 960, to any foreign country or U.S. possession (reduced as described in General Instruction I) in excess of the applicable limitation may be carried back 2 years and then forward 5 years. The excess must first be applied to the earliest of the 7 years to which it may be carried, then to the next earliest year, etc. (Section 904(c).)

If a credit was not claimed in a tax year to which the excess is carried, the excess is considered used in such year in the same manner as though a credit had been claimed. (Section 1.904-2(c) of the regulations.)

Transitional Rules

If excess foreign taxes are being carried over from tax years beginning before 1987 to tax years beginning after 1986, the following rules apply.

Excess foreign taxes paid on nonbusiness interest in tax years beginning before 1987 are carried over to the separate limitation of passive income.

Excess foreign taxes paid on all other income from sources outside the U.S. in tax years beginning before 1987 are generally carried over to the separate limitation of all other income from sources outside the U.S. The following exceptions, however, apply. If the corporation establishes to the satisfaction of the Secretary that the taxes were paid or accrued on shipping income, the excess foreign taxes paid in tax years beginning before 1987 will be carried over to the separate limitation of shipping income for computation of the credit in tax years beginning after 1986. Also, if the corporation meets the requirements of being a financial services corporation and establishes to the satisfaction of the Secretary that the excess foreign taxes were paid on financial services income, the taxes paid in tax years beginning before 1987 are carried over to the separate limitation of financial services income in tax years beginning after 1986. Any other excess

foreign taxes paid in tax years beginning before 1987 will be carried over to the corresponding separate limitation for tax years beginning after 1986. For example, excess foreign tax credits in the separate limitation of taxable income attributable to foreign trade income (section 904(d)(1)(C)) as in effect before the enactment of the Tax Reform Act of 1986 are carried over to the separate limitation of taxable income attributable to foreign trade income (section 904(d)(1)(G)) as in effect immediately after the enactment of the Tax Reform Act of 1986.

See sections 907(e) and 907(f) for rules governing the carryback and carryover of related taxes and foreign oil and gas extraction taxes paid or accrued in excess of the section 907(a) limitation.

M. Foreign Corporations Claiming Foreign Tax Credit.—Section 906 allows foreign corporations a foreign tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued under section 902) to any foreign country or U.S. possession with respect to income effectively connected with the conduct of a trade or business within the U.S. The credit is not applicable, however, if the tax is imposed by a foreign country or U.S. possession on income from U.S. sources solely because the foreign corporation was created or organized under the law of the foreign country or U.S. possession or is domiciled there for tax purposes.

The credit cannot be taken against any tax imposed by section 881 on income not effectively connected with a U.S. business.

For purposes of section 902(a) (relating to tax deemed paid) and section 78 (relating to dividend gross-up), a foreign corporation claiming a foreign tax credit will be treated as a domestic corporation.

N. Method of Reporting.—Report all amounts in U.S. dollars. If it is necessary to convert from foreign currency, attach a statement explaining how you determined the rate.

O. Research and Experimental Expenditures.—Section 1216 of the Tax Reform Act of 1986 provides that for tax years beginning after August 18, 1986, and on or before August 1, 1987, 50% of research and experimental expenditures paid or incurred in those years for research activities conducted in the U.S. shall be considered as allocable to U.S. sources. The remaining expenses are apportioned on the basis of gross sales or gross income.

Specific Instructions for Schedules A through E

Schedule A.—Taxable Income or (Loss) From Sources Outside the U.S.

All applicable columns in Schedule A must be completed line by line including the "Totals" line.

In columns 2 through 9 report all gross income or (loss) from sources outside the U.S. except: (1) gross income of foreign branches; and (2) gross income from activities described in section 863(b). In columns 11 and 12 report all deductions applicable to gross income reported in columns 2 through 9. See the instructions for columns 14 and 15 for treatment of foreign branches and section 863(b) income, respectively.

Report only gross income and deductions applicable to the determination of taxable income or (loss) from sources outside the U.S. of the type for which Form 1118 is being completed.

Column 1.—Enter the names of all foreign countries and U.S. possessions within which income is sourced, and/or to which taxes are paid, accrued, or deemed paid.

High seas income must be shown separately and be properly identified.

Column 2.—Report all dividends (before gross-up) from sources outside the U.S., including constructive distributions under section 951. See section 861(a)(2)(A) for treatment of dividends from a domestic corporation which meets the foreign business requirement.

Column 3.—Enter the dividend gross-up for taxes deemed paid. See General Instruction H for an explanation.

Column 4.—Enter all interest received from foreign sources.

Column 6.—Include gross income, whether in the form of compensation, commissions, fees, or otherwise derived from the performance of technical, managerial, engineering, construction, scientific or similar services. Do not include gross income from services performed through a foreign branch.

Column 7.—If there is gain on the sale or exchange of capital assets from sources outside the U.S., enter the entire amount of the gain in column 7. Also, see the instruction for column 11(d).

If there is a net capital loss or short-term capital loss from sources outside the U.S., see instruction K(2) for the reduction required in certain cases.

Column 9.—Include all other gross income from sources outside the U.S., except gross income of foreign branches and gross income from activities described in section 863(b). Attach a schedule identifying the gross income by type and by foreign country or U.S. possession of source.

Column 11(d).—Include all other deductions definitely allocable to income from sources outside the U.S. (dividends, interest, etc.) except deductions allocable to income of foreign branches and section 863(b) income.

Report the reduction of foreign source net capital gain here. (See instruction K(2).)

Column 12.—Section 862(b) provides that a ratable part of expenses, losses, and other deductions which cannot definitely be allocated to some item or class of gross income shall be deducted from gross income from sources outside the U.S. in arriving at taxable income from sources outside the U.S. Report in column 12 only that ratable part which applies to gross income reported in columns 2 through 9. Attach a schedule showing in detail the determination of this ratable part.

Column 14.—Attach a schedule showing in detail the determination of taxable income or (loss) of each foreign branch. Include, for each foreign branch, an income statement, balance sheet, and schedule of midyear remittances.

Column 15.—Section 863(b) and the regulations thereunder provide special rules for determining taxable income from sources outside the U.S. with respect to gross income derived partly within and partly outside the U.S. Report in column 15 taxable income or (loss) apportioned to sources outside the U.S. under these special rules. (Taxable income of foreign branches from sources outside the U.S. determined under these special rules should be reported in column 14, not column 15.) Attach a schedule showing gross income, definitely allocable deductions, the ratable part of deductions not definitely allocable, and the apportionment of taxable income to sources within and outside the U.S.

Schedule B

Part I.—Foreign Taxes Paid or Accrued and Deemed To Have Been Paid

All applicable columns in Schedule B, Part I, must be completed line by line, including the "Totals" line.

Report only foreign taxes paid or accrued and deemed paid with respect to the type of income for which Form 1118 is being completed.

Column 1.—If you claim a credit for taxes accrued, show both the date accrued and the date paid (if paid). (See General Instruction E.)

Column 2.—Enter the type of tax (income, war profits, or excess profits).

Column 4.—Enter foreign taxes paid or accrued on the line for the country or U.S. possession imposing the tax. Report all amounts in U.S. dollars. If amounts were converted from foreign currency, attach a schedule showing in detail how the conversion rates were determined. See General Instruction G for proof of credits required.

Include in column 4(g) tax withheld at source on income other than dividends, interest, rents, royalties, and license fees, and all other foreign taxes paid or accrued. Do not include taxes deemed to have been paid, which are reported in column 5.

Column 5.—Enter the tax deemed paid to each foreign country or U.S. possession from column 11, Schedule C.

Part II.—Computation of Foreign Tax Credit

Line 6b.—For tax years beginning after 1986, any separate limitation loss reduces income in other separate limitations before reducing U.S. income.

In subsequent tax years when there is income in the separate limitation loss category, the income will be recharacterized as income in the separate limitations that were reduced in earlier years.

Both U.S. losses and separate limitation losses are allocated on a pro rata basis.

Example: In tax year 1, corporation Y has a loss of $300 in the separate limitation of shipping income. Also in year 1, Y has income of $1,000 in the separate limitation of passive income, and $500 of income in the separate limitation of income from all other sources outside the U.S. Y allocates $200 of the separate limitation loss to reduce income in the separate limitation of

passive income. Y then allocates $100 of the separate limitation loss to reduce income in the separate limitation of income from all other sources outside the U.S.

To arrive at these figures, Y multiplies the separate limitation loss of $300 by a fraction. When computing the portion of the loss used to reduce the separate limitation of passive income, the numerator is $1,000. When computing the portion of the separate limitation loss used to reduce the separate limitation of all other income from sources outside the U.S., the numerator is $500. In both cases the denominator is $1,500 (the total of income in the separate limitations of passive income and all other income from sources outside the U.S.).

In year 2, corporation Y has income of $600 in the separate limitation of shipping income; $1,000 in the separate limitation of passive income; and $1,000 in the separate limitation of income from all other sources outside the U.S. Y must allocate the income in the separate limitation of shipping income since this separate limitation reduced income in other separate limitations in an earlier year. Y must allocate the income based on the loss allocated to each separate limitation. To do so Y divides $200 (the amount of loss allocated to the separate limitation of passive income) by $300 (the amount of loss in the separate limitation of shipping income) and multiplies the result by $1,000. The amount that is a result of this calculation is $666.67, but the recharacterization is limited to the amount of the loss used to reduce the separate limitation of passive income: $200. To determine the amount of income to be recharacterized as income from all other sources outside the U.S., Y divides $100 by $300 and multiplies the result by $1,000. The result of this computation is $333.33, but the amount recharacterized is limited to $100 (the amount of loss that is actually used to reduce income in the separate limitation of all other income outside the U.S.).

Line 6d.—Allocation of Net U.S. Losses

Enter on line 6d the pro rata share of the net U.S. loss that applies against the separate limitation for which the Form 1118 is computed.

Example: In 1987, corporation X has a net loss of $100 from U.S. sources. In the same tax year, X has $500 of income in the passive income separate limitation and $250 of income in the separate limitation of dividends from a DISC or former DISC. X must allocate the net U.S. loss between the separate limitations for passive income and dividends from a DISC or former DISC. To do so, X adds the total income from foreign sources and divides this amount into the amount of income in each separate limitation. X then multiplies the result by the $100 net U.S. loss. The result is that X must allocate $66.67 of the $100 net U.S. loss to the separate limitation of passive income and $33.33 of the $100 U.S. loss to the separate limitation of dividends from a DISC or former DISC.

Part III.—Summary of Credits From Separate Forms 1118

Complete Schedule B, Part III, on only one Form 1118. Enter the credits from Schedule B, Part II, line 15, of the separate Forms 1118 on lines 1 through 9, Part III.

The following instructions are to be used when the dividends are out of earnings and profits accumulated in tax years beginning after 1986:

Schedule C

Column 2.—If the dividend is paid out of earnings and profits accumulated in tax years beginning after 1986, do not complete column 2.

Column 4.—If the computation is for a second or third tier foreign corporation under section 960(a), also indicate (in parentheses) the country of incorporation of such foreign corporation.

Column 5.—Enter the undistributed earnings and profits accumulated in tax years beginning after 1986. See page 1 for a definition.

Column 6.—Enter taxes paid or accrued on earnings and profits accumulated in tax years beginning after 1986. In tax years beginning after 1987, reduce these taxes by any taxes used to reduce taxable income in prior years.

Schedule D

Column 1.—Enter the name of the second-tier foreign corporation and its related first-tier foreign corporation.

Column 2.—If the dividend is paid out of earnings and profits accumulated in tax years beginning after 1986, do not complete column 2.

Column 4.—Same as column 5, Schedule C.

Column 5.—Same as column 6, Schedule C.

Schedule E.—Follow the same instructions for Schedule D, except that column 6 is not completed, and the amount of deemed paid credit (column 10, Schedule E) is carried to column 6, Schedule D.

The following instructions are to be used when computing the deemed paid foreign tax credit when the dividend is paid out of earnings and profits accumulated in tax years beginning before 1987.

If there are no instructions for a column, use the column instructions for dividends paid out of earnings and profits accumulated in tax years beginning after 1986.

Schedule C

Computation of Taxes Deemed To Have Been Paid by Domestic Corporation Filing This Return

Column 2.—If dividends are from the accumulated profits of more than 1 year, the tax deemed to have been paid must be computed and shown on a separate line for each year.

Computations under section 902(a) and 960(a) for a first-tier foreign corporation, even though for the same year, must be made on separate lines. Further, separate lines must be used for computations under sections 902(a) and 960(a) with respect to the foreign income taxes deemed paid by a first-tier foreign corporation under section 902(b)(1). (See the instructions that follow.)

Column 3.—If computation is for a second-tier or third-tier foreign corporation under section 960(a), also indicate (in parentheses) the country of incorporation of the first-tier foreign corporation of such second-tier or third-tier foreign corporation.

Column 5.—Enter the gains, profits, and income for the tax year from which the dividend was paid.

Column 6.—Enter the amount of foreign taxes paid or accrued on the gains, profits, and income entered in column 5. See General Instruction G for proof of credit required, and General Instruction I for reduction of foreign taxes for failure to furnish information required under sections 6038 and 901(j).

See the instructions that follow for exclusions from the earnings and profits of a first-tier foreign corporation for purposes of applying sections 902(a) and 960(a) with respect to the foreign income taxes deemed paid by such first-tier foreign corporation under section 902(b)(1).

Column 7.—Earnings and profits for the tax year. Subtract column 6 from column 5.

Column 8.—Enter the amount of dividends: (1) paid or constructively distributed by the related foreign corporation; and (2) paid or deemed distributed by the DISC or former DISC to the domestic corporation.

See the instructions that follow for certain distributions made by a first-tier foreign corporation to the domestic corporation which are not treated as dividends for purposes of applying section 902(a) with respect to the foreign income taxes deemed paid by such first-tier foreign corporation under section 902(b)(1).

For purposes of section 902, IRS may determine from which year's accumulated profits the dividends were paid.

Column 9.—Enter the taxes deemed paid from column 10, Schedule D.

Column 10.—Add columns 6 and 9.

Column 11.—Tax deemed to have been paid. Divide column 8 by column 7 and multiply the result by column 10.

Schedule D

Computation of Tax Deemed To Have Been Paid by First-Tier Foreign Corporation

Column 1.—Enter the name of the second-tier foreign corporation and its related first-tier foreign corporations.

Column 2.—If dividends are from accumulated profits of more than 1 year, the tax deemed to have been paid must be computed and shown on a separate line for each year.

Column 3.—Enter the country of incorporation of the foreign corporation.

Column 4.—Enter the gains, profits, and income for the tax year from which the dividend is paid.

Column 5.—Same as Schedule C, column 6.

Column 6.—Earnings and profits for the year. Subtract column 5 from column 4.

Column 7.—Enter dividends paid to the first-tier corporation.

Column 8.—Enter the taxes deemed to have been paid from column 10, Schedule E.

Column 9.—Add columns 5 and 8.

Column 10.—Tax deemed to have been paid. Divide column 7 by column 6 and multiply the result by column 9.

Schedule E

Computation of Tax Deemed To Have Been Paid by Second-Tier Foreign Corporation

Column 2.—Enter the tax year from which the dividend was paid. If the dividend was paid out of the earnings of more than one year, enter the portion of the dividend that was paid out of the earnings of the earlier tax year on one line. Enter the portion of the dividend that was paid out of earnings of the later tax year on another line. Then identify in column 2 the year for each portion of dividend by entering the tax year from which the earnings and profits that gave rise to the dividend. Finally, compute the deemed paid credit as if each portion of the dividend was a separate dividend.

Column 4.—Enter the gains, profits, and income for the tax year from which the dividend was paid.

Column 5.—Enter the foreign taxes paid or accrued on the gains, profits, and income for the year from which the dividend was paid.

Column 6.—Make no entry.

Column 7.—Earnings and profits. Subtract column 5 from column 4.

Column 8.—Enter the amount of dividends paid to the third-tier foreign corporation.

Column 9.—Enter the amount from column 5.

Column 10.—Tax deemed to have been paid. Divide column 8 by column 7 and multiply the result by column 9. Enter this amount in column 8, Schedule D.

Credit for Taxes of Foreign Corporations Deemed To Have Been Paid on Dividends Accumulated in Tax Years Beginning Before 1987.—

(1) Under Section 902.—If a domestic corporation owns 10% or more of the voting stock of a foreign corporation (first-tier foreign corporation) from which it receives a dividend, the domestic corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid, accrued, or deemed paid by the first-tier foreign corporation. (Section 902(a).)

If the first-tier corporation owns 10% or more of the voting stock of a second-tier foreign corporation from which it receives a dividend, and the product of the percentage of voting stock owned by the domestic corporation in the first-tier foreign corporation and the percentage of voting stock owned by the first-tier foreign corporation in the second-tier foreign corporation equals at least 5%, the first-tier foreign corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid, accrued, or deemed paid by the second-tier foreign corporation. (Sec. 902(b)(1).)

If the second-tier foreign corporation owns 10% or more of the voting stock of a third-tier foreign corporation from which it receives a dividend, and the product of the percentage of voting stock owned by the domestic corporation in the first-tier foreign corporation, the percentage of voting stock owned by the first-tier foreign corporation in the second-tier foreign corporation, and the percentage of voting stock owned by the second-tier foreign corporation equals at least 5%, the second-tier foreign corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid or accrued by the third-tier foreign corporation. (Section 902(b)(2).)

You may not claim a credit under section 902 for taxes paid by a registered foreign investment company to which the election under section 1247(f) applies. (Section 1.1247-4(b)(vii) of the regulations.)

For purposes of section 904, all foreign income taxes paid or deemed paid by a first-tier foreign corporation, and deemed paid by the domestic corporation under section 902, are deemed to have been paid to the foreign country or U.S. possession under the laws of which such first-tier foreign corporation is created or organized. (Section 1.902-1(h)(2) of the regulations.)

(2) Under Section 960(a).—If a domestic corporation is required under section 951 to include in gross income an amount attributable to the earnings and profits of a foreign corporation (first-tier foreign corporation) of which it owns 10% or more of the voting stock of a foreign corporation (second-tier foreign corporation) of which such first-tier foreign corporation owns 10% or more of the voting stock, the domestic corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid, accrued, or deemed paid by such first-tier foreign corporation, or paid or accrued by such second-tier foreign corporation.

For amounts included in gross income under section 951, a credit is allowed for taxes deemed to have been paid by a third-tier foreign corporation, and the percentage-of-voting-stock requirements are the same as under section 902(b)(3)(B).

(3) Mixed Application of Sections 902 and 960(a).—Section 902(b)(1) applies to all dividends received by a first-tier foreign corporation from a second-tier foreign corporation (as defined for purposes of section 960(a)) other than dividends attributable to earnings and profits of such second-tier foreign corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such second-tier foreign corporation. (Section 1.960-2(b) of the regulations.)

Section 902(a) applies to all dividends received by the domestic corporation for its tax year from a first-tier foreign corporation, other than dividends attributable to earnings and profits of such first-tier foreign corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such first-tier foreign corporation. (Section 1.960-2(c) and (d) of the regulations.)

If a first-tier foreign corporation for its tax year receives from a second-tier foreign corporation (as defined for purposes of section 960(a)) dividends to which section 902(b)(1) applies and other dividends to which section 902(b)(1) does not apply, then in applying sections 902(a) and 960(a) with respect to the foreign income taxes deemed paid under section 902(b)(1) by such first-tier foreign corporation for such tax year, the earnings and profits of the first-tier foreign corporation shall be considered not to include its earnings and profits attributable to such other dividends from the second-tier foreign corporation; and for the purposes of so applying section 902(a), distributions to the domestic corporation from such earnings and profits which are attributable to such other dividends from the second-tier foreign corporation shall not be treated as a dividend. (Section 1.960-2(d) of the regulations.)

Computations under section 902 must also make allowance for any taxes deemed to have been paid by a third-tier foreign corporation under section 960(a).

Schedule F

Computation of Reduction of Oil and Gas Extraction Taxes

Attach Schedule F (Form 1118) if you derived any foreign oil and gas extraction income during the tax year.

Schedule G

Separate Limitation Losses and Overall Foreign Losses

For tax years beginning after 1986, any corporation that has a separate limitation loss or an overall foreign loss will have to complete Schedule G (Form 1118) and attach it to Form 1118.

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